We're in the money

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Abstract (Document Summary)

At certain periods during the year, when liquidity becomes an issue, credit union executives must employ various techniques to meet loan demand. One of these techniques, a pooled loan sale, gives credit union executives a more tailored and time-sensitive approach for increasing available loan funds that may allow the credit union to retain servicing rights. The essential issues in a transaction of this type generally include: 1. creating a suitable structure under which to accomplish the transaction, 2. reducing the risk of loss to the investor through potential loan defaults by purchasing insurance for the pool of loans or by creating a structure in which the credit union retains a subordinated piece of the loan pool, 3. creating a suitable mechanism for payments to be made to the investor, 4. complying with applicable securities laws, and 5. developing an accounting treatment for the pooled loan sale.

Full Text (1607 words)

An important tenet of the credit union movement is providing service to members. The most significant service that a credit union can provide is, of course, a member loan. In a perfect world and under ideal circumstances, funds would always be available to meet the level of loan demand. In the real world of credit union managment, however, there are certain periods during the year when liquidity becomes an issue. Then the executives must employ various techniques to meet loan demand.

One of these techniques, a pooled loan sale, gives credit union executives a more tailored and time-sensitive approach for increasing available loan funds that may allow the credit union to retain servicing rights.

What is a "pooled loan sale" and in what sense is it 'tailored" and "time sensitive?" The term "pooled loan sale" is

derived from the fact that a credit union will hold a variety of loans on its books at any given point in time. By segregating certain loans, such as mortgage loans, home equity loans or car loans, the credit union executives creates a pool of available loans that can be sold to an investor.

The sale of this pool of loans removes the loans from the credit union's balance sheet and increases available cash for lending purposes. Because creating the pool and making it available for sale are decisions largely within the control of the credit union executive, we refer to the pooled loan sale as "tailored" and "time sensitive." It also is "time sensitive" because the credit union executive may determine with more certainty within what period of time a desired level of liquidity may be achieved and at what price.

The key to a successful pooled loan sale is to keep it simple. Investors are interested in quality loans that exhibit a regular payment history. Because the loan delinquency rate within most credit unions is so inconsequential, many credit union loans are good candidates for pooling.

Once a pool of loans available for sale is segregated, the credit union may want to solicit bids from groups of investors. By directly approaching investors, the credit union can eliminate the expense of using a broker whose fees are usually 1 percent to 2 percent of the size of the loan pool. As investors review the pool, they filter it using the criteria by which they identify suitable loans. Part of this process will involve the credit union removing certain loans from the pool and replacing them with others. Once the investor and the credit union come to an agreement on the size and characteristics of the pool and the credit union is satisfied with the bid amount, the credit union can take further steps to effect the sale.

POOLING PROCESS

The essential issues in a transaction of this type generally include: creating a suitable structure under which to accomplish the transaction; reducing the risk of loss to the investor through potential loan defaults by purchasing insurance for the pool of loans or by creating a structure in which the credit union retains a subordinated piece of the loan pool; creating a suitable mechanism for payments to be made to the investor; complying with applicable securities laws; and developing an accounting treatment for the pooled loan sale. These issues are more fully discussed below.

FIVE KEY POINTS

Suitable structure. Typically, the credit union packaging a pool of loans for sale to an investor creates a legal entity called a grantor trust. There are two reasons for the creation of such an entity. First, the investor must be assured that the pool of loans is removed from the bankruptcy estate of the credit union. Second, the operations of a grantor trust are not subject to taxation. Rather, the investors in the trust pay taxes on their ratable portion of the trust's income. A pooling and servicing agreement is entered into among the seller of the loan pool (in this case the credit union), the servicer (also, in this case the credit union), and the trustee (typically a financial institution with trust powers). The pool of loans is transferred to the grantor trust and administered by the trustee. The investor acquires a certificate evidencing its beneficial interest in the trust. As the receivables liquidate, the investor obtains its ratable portion of the trust's assets.

Reducing the risk of loss to the investor. In any sale of pooled loans, the investor will desire some level of assurance that the loans themselves represent strong credits and will be repaid and repaid on time. Some investors may require that the certificates representing the investor's interest in the loan pool be rated by a recognized rating agency. In order to protect against losses from nonperformance of the loans, investors may request that the credit union provide some form of guaranty, bond or letter of credit, the proceeds of which would be used to buy back defaulted receivables. Alternatively, the investor might require the credit union to take back a subordinate interest in the trust. These types of portfolio supports are generally referred to as "credit enhancements."

Mechanism for payments to the Investor. An important consideration for the investor is to be assured that the payment mechanism works. Where the credit union creates a trust to hold the receivables, and the credit union continues to act as servicer of the loans, it is most likely that the investor will require that a trust account be established at a mutually satisfactory depository institution. The credit union would then deposit payments made under the receivables to that trust account and disbursements would be made from the account.

Compliance with applicable securities laws. Generally federal and state securities laws exempt the securities of insured depository institutions from registration with the Securities and Exchange Commission or the applicable

state agency. Because the participation certificate in the example discussed above is issued by the trust, the insured depository institution exemption would not be available. In a pooled loan sale by a credit union, however, the transaction could be accomplished by a private sale to an investor. In this case, an exemption from registration is available.

Accounting treatment. The authoritative accounting literature relating to receivables sold with recourse, such as pooled loan sales, is FASB Statement 77. Statement 77 applies to transfers of receivables that are structured as sales transactions. A transfer of receivables with recourse should be accounted for as a sale if all of the following conditions are met: (a) the transferor surrenders control of the future economic benefits embodied in the receivables; (b) the transferor's obligation under the recourse provisions can be reasonably estimated; and (c) the transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions. The credit union should work with its accountants when creating a suitable structure for the investors in determining if the structure meets sale treatment according to Statement 77.

TIMING AND TAILORING

Naturally, a credit union contemplating a pooled loan sale will be concerned about the time it takes to complete the transaction. An initial pooled loan sale may take as long as 90 days to complete. Investors unfamiliar with the credit union may require the loans being pooled for sale to be thoroughly checked against the original loan documentation and may inquire about loan delinquency, foreclosure and default histories. Also, the initial drafting of legal documents and accounting interpretations tends to lengthen the initial sale. Subsequent sales should take fewer than 60 days I to complete due to investor familiarity with the credit union and the familiarity of the credit union with the pooled loan sale process.

The discussion above focuses on only one form of a pooled loan sale. Many variations are found in today's market, and sales may be tailored to meet the needs of the credit union and the investor.

Pooled loan sales may be used, for example, to group and market small loans that would be difficult to sell on a stand-alone basis. Successful sales involve little or no change in the manner in which a credit union services its loans and yield simple-to-understand debt instruments that match the needs of the investor.

Credit unions today may benefit from two decades of development in the accounting and financial services industries in analyzing pooled loan sales as an alternative means of obtaining financing.

Other benefits of a pooled loan sale include the ability to match assets with liabilities, the retention of servicing revenue and the diversification of the investor base. Because of this diversity, the credit union is better able to raise needed funds at different times during the year without having to rely solely on attracting additional CD purchases by members.

From time to time, credit unions need additional liquidity to introduce new products or loans. Credit unions typically increase CD or share deposit rates to raise funds. Though effective, the credit union executive will not be able to predict the amount of funds that a given increase in rates will raise nor what rate is needed to raise the desired amount of funds.

Increasing share deposit and CD rates to attract additional funds is equivalent to short-term borrowing to finance long-term growth. As an alternative, the pooled loan sale is a simple and practical method by which to obtain necessary funds to serve member needs and to better manage growth.

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